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No. .....

Supreme Court, U.S.
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In The Supreme Court of The United States

OCTOBER TERM, 1971

COMMONWEALTH OF PENNSYLVANIA,
Appellee

v.

EMHART CORPORATION,
Appellant

On Appeal from the Supreme Court of Pennsylvania.

JURISDICTIONAL STATEMENT

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JURISDICTIONAL STATEMENT

THE OPINIONS BELOW

The opinion of the Supreme Court of Pennsylvania, as yet unpublished in the official reports of that court, is reported unofficially in 278 A.2d 917 and appears in Appendix A, pp. 18-30, *infra*. The opinion of the Court of Common Pleas of Dauphin County, as yet unpublished, appears in Appendix B, pp. 31-48, *infra*.

STATEMENT OF THE GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED

(i) This case involves the unconstitutional double taxation by Pennsylvania of a gain resulting from the sale of stock by a Connecticut manufacturing corporation. The gain was fully taxed by Connecticut, the corporation's commercial domicile. The stock sold had no connection with Pennsylvania, or Appellant's activities in Pennsylvania. Appellant appeals from an order and final judgment of the Supreme Court of Pennsylvania affirming in part a judgment and order of the Court of Common Pleas of Dauphin County in which the lower court rejected Appellant's contention that the application of the three-factor income apportionment formula contained in Pennsylvania's Corporate Net Income Tax Act, appearing in pertinent part in Appendix C, pp. 54, 62, *infra*, violated the Due Process Clause of the Fourteenth Amendment of the United States Constitution and sustained and enforced a tax settlement by the Commonwealth of Pennsylvania based on such an apportionment formula. Judgment in accordance with the order of the Supreme Court of Pennsylvania was entered in the Court of Common Pleas of Dauphin County on July 20, 1971.

(ii) The judgment of the Supreme Court of Pennsylvania sought to be reviewed in these proceedings was entered on June 28, 1971. No order respecting a rehearing has been filed. Notice of Appeal, appearing in Appendix D, p. 63, *infra*, was filed in the Supreme Court of Pennsylvania on September 17, 1971 and a copy sent to the Court of Common Pleas of Dauphin County.

(iii) Jurisdiction of this appeal is conferred on this Court by 28 U.S.C. 1257(2).

(iv) Cases sustaining the jurisdiction of this Court are:

Norfolk & Western Railway Co. v. *Missouri State Tax Commission,* 390 U.S. 317 (1968);

Portland Cement Co. v. *Minnesota,* 358 U.S. 450 (1959);

Bulter Brothers v. *McColgan,* 315 U.S. 501 (1942);

Hans Rees' Sons, Inc. v. *North Carolina,* 283 U.S. 123 (1931);

See *Dahnke-Walker Milling Co.* v. *Bondurant,* 257 U.S. 282, (1921).

(v) The statute involved is Pennsylvania's Corporate Net Income Tax Act of May 16, 1935, as re-enacted and amended, P.L. 208, PA. STAT. tit. §3420 (1964), Appendix C, pp. 54-62, *infra.*

QUESTION PRESENTED

Is Pennsylvania's three-factor income apportionment formula, which fails to distinguish between business and nonbusiness income, constitutionally invalid when applied to gains from the sale of intangible property (i.e., corporate securities) where (1) taxpayer is incorporated under the laws of Connecticut, (2) taxpayer's commercial domicile is in Connecticut, (3) all of the gains are subject to tax, and were taxed, by Connecticut, (4) taxpayer's principal business, and its sole in-state activity within Pennsylvania, was manufacturing, and (5) the gains arose not in the ordinary course of taxpayer's business, but rather from divestment of assets acquired through a merger occurring less than six months prior to the sale?

STATEMENT OF THE FACTS OF THE CASE

The parties have stipulated to the facts relevant to the question presented by this appeal in the proceedings below. Record at 6a - 19a.

(i) *Gain Upon Sale of Monsanto Stock*

Pennsylvania's taxing jurisdiction over Appellant is based on a manufacturing plant in Lancaster, Pennsylvania acquired by Appellant in 1962. Prior to that time Appellant, a Connecticut manufacturing corporation with its home office and principal place of business in that state, had done no business in Pennsylvania. Since 1962 its Pennsylvania business activity has been limited to the manufacturing activity of its Lancaster plant.

The transaction giving rise to this appeal is Appellant's sale of 180,518 shares of Monsanto Chemical Company stock on November 19, 1964, for $15,000,000.

Appellant acquired the Monsanto stock as the result of a merger. Originally owned by a Delaware manufacturing corporation ("Manufacturing"), the stock was acquired by that corporation as consideration in a tax-free exchange in which it transferred to Monsanto a 50 percent interest in a Delaware subsidiary. On June 30, 1964, Manufacturing merged into Appellant, thus making Appellant the owner of the Monsanto stock. Prior to the merger Manufacturing had neither plant nor office in Pennsylvania. At all times relevant, the business of Manufacturing and of Appellant remained separate and distinct from Monsanto.

In February, 1964, four months prior to its merger with Appellant and while merger negotiations were under way,

Manufacturing borrowed $30,000,000 from Bankers Trust Company of New York. At the time of the loan, there was an unwritten understanding among the Bank, Manufacturing and Appellant that proceeds from the sale of the Monsanto stock would be used to reduce the loan. Manufacturing applied the proceeds of the loan to purchase 602,089 shares of Appellant's stock at $50 per share, thereby thwarting attempts by various persons to acquire control of Appellant.

Upon the merger of Manufacturing into Appellant, Appellant retired the 602,089 shares of its own stock acquired by reason of the merger, and on November 19, 1964 sold 180,518 shares of the Monsanto stock for $15,000,000, thereupon realizing a capital gain of $13,637,858.[1]

In reporting its 1964 income to Connecticut, Appellant included the entire gain in accordance with that state's statute taxing domestic corporations.[2]

In reporting its income to Pennsylvania, Appellant excluded the gain from the application of that state's three-factor income apportionment formula on the ground that such income bore no relation to the exercise of its franchise to do business in Pennsylvania. Appellant reported total income subject to the apportionment formula in the amount of $5,740,012 and computed its Pennsylvania corporate income tax liability as $9,462.42. The Pennsylvania Depart-

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[1] The market value of the Monsanto stock at the time of the merger was $79 per share. It was sold four and one half months later at $83.075 per share, a gain of only $4.075 per share during the time it was owned by Appellant. Record 121a. Nevertheless, Pennsylvania applied its apportionment formula to the full gain of $75.515 per share.

[2] CONN. GEN. STAT. ANN. tit. 12 § 12-218 (1964, 1969 Supp.)

ment of Revenue, however, included the gain from the Monsanto stock in the base amount to which it applied the apportionment formula and, with other minor adjustments, computed Appellant's tax as $32,792.11.

(ii) *Proceedings Below.*

Appellant filed a timely petition for resettlement with the Pennsylvania Department of Revenue, which was refused. Appellant then petitioned for review before the Pennsylvania Board of Finance and Review, asserting, among other things, that federal constitutional limitations discussed in the leading case *Commonwealth* v. *Columbia Gas & Electric,* 336 Pa. 209, 8A.2d 404 (1939), precluded Pennsylvania from taxing income wholly unrelated to the business carried on in Pennsylvania by Appellant. Appellant's Petition for Review to the Board of Finance and Review, Record at 118a. Its petition for review was denied. Record at 107a.

Appellant next appealed to the Court of Common Pleas of Dauphin County, alleging as an objection that

> [t]he settlement is in violation of Section 1 of the Fourteenth Amendment of the Constitution of the United States . . . Appellant's Appeal and Specification of Objections to the Court of Common Pleas of Dauphin County, Record at 2a.

There the matter was tried before the court in banc upon a stipulation of facts. The court affirmed the action of the Pennsylvania Department of Revenue. Record 38a. In an opinion explaining its order, the court found that the gain from the sale of the Monsanto stock contributed to a "scheme of corporate functioning or the business potency of the corporation within the Commonwealth" and that Appellant had failed to "overcome the presumption of con-

stitutionality which is inherent both in the statute and in the application thereof." Appendix B, p. 46, *infra.*

Appellant filed his general exceptions to the Order of the Court of Common Pleas and appealed to the Supreme Court of Pennsylvania. Record at 40a - 41a. In its brief before that Court Appellant contended that income bearing no relation to the exercise of the privilege of doing business in Pennsylvania must be excluded from the application of the Pennsylvania apportionment formula, citing the leading Pennsylvania case considering the Due Process limitations on Pennsylvania's power to tax for foreign corporations, *Commonwealth* v. *Columbia Gas & Electric Corp., supra.* Brief for Appellant before the Supreme Court of Pennsylvania at 17.

The Supreme Court of Pennsylvania affirmed the decision of the lower court sustaining Pennsylvania's taxation of the gain from the Monsanto stock. By affirming the lower court decision and by distinguishing *Columbia Gas & Electric Corp.*, the court rejected Appellant's objection, duly raised and considered below, that application of the Pennsylvania income apportionment formula to the gain from the Monsanto stock deprived Appellant of property without due process of law in violation of the Fourteenth Amendment.

THE FEDERAL QUESTION PRESENTED IS SUBSTANTIAL

(i) ***The decision below raises an important and timely question as to the constitutional limits in applying the three-factor apportionment formula which has been adopted by most of the states.***

It is well established that the state of a corporation's commercial domicile, through its in personam jurisdiction over that corporation, can tax its intangible property unless that property has established a business situs elsewhere. *Wheeling Steel Corporation* v. *Fox,* 298 U.S. 193 (1936). Most states accede to this principle and exclude from the application of their income apportionment formulae gains from the sale of intangible property if the taxpayer has a commercial domicle elsewhere. See the Uniform Division of Income for Tax Purposes Act, appearing in Appendix E, pp. 64-70, *infra,* and discussed at pp. 9-10, *infra.* But not all states follow this rule. *Emhart* illustrates how inconsistencies among the states in their allocation of income related to the sale of intangibles can impose an unconstitutional burden of double taxation on multi-state corporations.

Appellant's plight of being fully taxed on a gain from the sale of intangibles in Connecticut, its commercial domicile, and then being taxed again on the same gain in Pennsylvania through application of that state's three-factor apportionment formula is far from unique. Other states, besides Pennsylvania, apply an apportionment formula to the income of multi-state manufacturing corporations without distinguishing between taxpayer's business and nonbusiness income.[3] Still other states have, or are considering, similar methods of taxing such gains. In Delaware, for example, a provision allowing an exclusion from the base amount for income from the sale of intangible property

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[3] See MINN. STAT. ANN. § 290.19 (1971 Supp.) R.I. GEN. LAWS ANN. § 44-11-14 (1971); TENN. CODE ANN. § 67-2707 (1955); VT. STAT. ANN. tit. 32, § 5835 (1971 Supp.). The statutes of these states, however, have a savings clause which permits the taxing authority to use another method of apportionment where application of the statutory formula reaches an inequitable result.

was repealed in 1969.[4] Increasing fiscal pressure on state governments may be expected to lead still more state taxing authorities to try to extend their taxing power to reach extraterritorial income of multi-state corporations.[5]

Inconsistencies in state taxing policies and overlapping state taxing jurisdictions have long plagued corporations engaged in multi-state activities. In many instances, as in *Emhart,* the result has been that such corporations have borne a disproportionate tax burden compared to single-state businesses.

The problems raised by nonuniform state tax treatment of extraterritorial income has been widely recognized in recent years and responses have been initiated on many levels. Through the Willis Committee, Congress has studied the matter extensively, although its efforts have, as yet, produced no comprehensive federal legislation. "State Taxation of Interstate Commerce," Report of the Special Subcommittee on State Taxation of Interstate Commerce Committee of the Judiciary, House of Representatives, 88th Cong., 2d Sess., H.R. No. 1480. In 1957, the National Commission of Uniform State Laws approved the Uniform Division of Income for Tax Purposes Act, appearing in Appendix E, pp. 63-70, *infra.* Since then, over twenty-six states and the District of Columbia have adopted this Act or used it as their model for the apportionment of the income of multi-state corporations.[6] In addition, nine other

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[4] DEL. CODE ANN. tit. 30, § 1903 (1968, 1971 Supp.); *cf.*, W. VA. CODE ANN. § 11-24-7 (1966, 1971 Supp.).

[5] See note 11 *infra.*

[6] Alabama, Alaska, Arkansas, California, District of Columbia, Florida, Hawaii, Idaho, Indiana, Kansas, Kentucky, Maine, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Okla-

states have provisions for apportioning income similar to the Uniform Act.[7] *See generally* Keesling and Warren, *California's Uniform Division of Income for Tax Purposes Act*, 15 U.C.L.A. L. REV. 156 (1967).

In recent years this Court also has been responsive to problems of multiple taxation resulting from inconsistencies in state apportionment formulae. Thus in reversing a decision of the District of Columbia sustaining the application of a single-factor apportionment formula based on sales alone, this Court departed from its practice of not disturbing interpretations of the District of Columbia Code by the Court of Appeal of that circuit and granted certiorai because, it explained,

> [this case] has an impact not confined to the Potomac's shores, but reaching far beyond. [The decision below] lend[s] sanction to an apportionment formula seriously at variance with those prevailing in the vast majority of states and creates substantial dangers of multiple taxation. *General Motors Corp.* v. *District of Columbia*, 380 U.S. 553, 556-57 (1965).

In *Norfolk & Western Railway Co.* v. *Missouri State Tax Commission*, 390 U.S. 317 (1968), this Court reached the constitutional issue it had avoided in *General Motors* through statutory interpretation by holding that the application of a Missouri apportionment formula, which had

homa, Oregon, South Carolina, Texas, Utah, Virginia and Washington. The above list includes states that have adopted the Multi-State Compact, which includes the provisions of the Uniform Act. The Compact will not become effective until constitutional impediments to states' entering into such a Compact have been removed. See U.S. CONST., art. I, § 10.

[7] Arizona, Connecticut, Colorado, Georgia, Illinois, Mississippi, Maryland, South Dakota and Wisconsin.

resulted in taxes grossly disproportionate to taxpayers' in-state business activity, was constitutionally invalid because it imposed an illegal restraint on interstate commerce and violated the Due Process Clause of the Fourteenth Amendment. See also *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931); *see generally* Hellerstein, *Recent Developments in State Tax Apportionment and the Circumspection of Unitary Business*, 21 NAT. TAX J. 487 (1968).

This case, by questioning the propriety of the application of the widely adopted three-factor income apportionment formula to nonbusiness, extraterritorial revenues unrelated to taxpayer's in-state activities, affords this Court an important opportunity to speak on the constitutional limits of the use of this formula and to restrain other states from transgressing these limits.

(ii) *The decision below exceeds established constitutional limitations on state taxing power and encourages the indiscriminate application of the three-factor apportionment formula to revenues clearly unrelated to in-state business activity of multi-state corporations.*

It is well settled that a state's power to tax is limited to its power to otherwise control the objects of its tax. *Connecticut General Life Insurance Co.* v. *Johnson*, 303 U.S. 77 (1938). Formulae for apportioning the business income of multi-state corporations giving equal weight to the three factors of tangible property, payroll and sales have been upheld against constitutional challenge on their face. *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). However, where the application of such formula yields a state tax liability disproportionate to the in-state property owned by, and

business activity of, a multi-state corporation, this Court has found the result contrary to the Due Process Clause of the Fourteenth Amendment. *Norfolk & Western Railway Co.* v. *Missouri State Tax Commission, supra;* see *General Motors Corp.* v. *District of Columbia, supra; Commonwealth* v. *Columbia Gas & Electric Corporation, supra.*

These constitutional considerations have led most states to distinguish between business and nonbusiness income in applying the three-factor apportionment formula. Thus under the Uniform Division of Income Tax Purposes Act, which serves as the model for apportionment statues in twenty-six states plus the District of Columbia,[8] the apportionment formula is applied only to "business income." See Uniform Act, Section 1a, Appendix E, p. 64, *infra.* Under the Uniform Act "business income" is defined as

> income arising from transactions and activity in the regular course of taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business. Uniform Act, Section 1a, Appendix E, p. 64, *infra.*

Other income (i.e., nonbusiness income) is allocated to the situs of the property producing the income; however, capital gains from sales of intangible property are allocable to the taxing state only if taxpayer's commercial domicile is in that state. Uniform Act, Section 6(c), Appendix E, p. 66, *infra.*

In addition to the states modeling their apportionment

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[8] See note 6 *supra.*

formula after the Uniform Act, seven other states follow a pattern, similar to the Uniform Act, of allocating certain income according to situs and applying an apportionment formula only to the remaining net income.[9] In most cases these states allocate gains from the sale of intangibles to taxpayer's commercial domicile.

Pennsylvania does not distinguish between business and nonbusiness income in applying its apportionment formula. Rather, it applies its apportionment formula to taxpayer's net income as reported on its federal return. However, to deal with instances where this method of allocation will work an unconstitutional result, the Pennsylvania statue contains a saving clause that allows the Department of Revenue to exclude from the application of the formula:

> net income from the business or property which bears no relation to the exercise of the Pennsylvania franchise. Pennsylvania Corporate Net Income Tax Act, Appendix C, p. 61, *infra*.

This provision would appear to save the statute from a constitutional challenge on its face.

While this provision is analogous to the exclusion of nonbusiness income in states adopting the Uniform Act, the failure of the Pennsylvania statute to delineate clearly what types of income bear no relation to the exercise of the Pennsylvania franchise invites the sort of missapplication of the apportionment formula and resulting double taxation that occurred in *Emhart*.

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[9] See note 7 *supra*.

Prior to the merger of Appellant and Manufacturing, the Monsanto stock was owned by Manufacturing, which had no relation to Pennsylvania. The proceeds from the sale of the stock were used to discharge a debt of Manufacturing arising before the merger. Nearly 95 percent of the gain was attributable to the period from 1935 to the date of the merger. Nevertheless, because Appellant, a multistate manufacturing firm with one plant in Pennsylvania, engaged in business in that state, the Pennsylvania court held that the gain from the sale of the Monsanto stock could be taxed under that state's three-factor apportionment formula, resulting in 1964 tax liability for Appellant nearly four times greater than if the gain had been excluded.

Under the Uniform Act the gain would have been allocated to Connecticut, Appellant's commercial domicile, and would not have been subject to the apportionment formula. Uniform Act, Section 6(c), Appendix E, p. 66, *infra*.

The rationale of the Pennsylvania court was that

> the capital gain proceeds from this sale contribute substantially to a scheme of corporate functioning and the business potency of Appellant. *Commonwealth* v. *Emhart*, Appendix A, p. 24, *infra*.

The court's reasoning is fundamentally flawed because it fails to recognize that a nexus must exist between the activity producing the gain and Appellant's in-state activity. Indeed, instead of focusing on the relevant relationship, the court concentrates on the use to which the gain was put, rather than the activity that produced the gain. Thus the court ignores the facts that 95 percent of the appreciation in value of the Monsanto stock occurred before

Appellant acquired the stock and that Appellant's manufacturing activity in Pennsylvania was in no way responsible for, or related to, that appreciation in value. Nor was Appellant's manufacturing activity in Pennsylvania related to or responsible for the balance of the gain generated, rather the appreciation in value of the Monsanto stock resulted from Monsanto's activities and increased investor expectations about the profitability of that company.

Yet, the significance of the court's rationale is not that it is erroneously applied to the *Emhart* facts, but that the rationale itself is illogical and that the breadth of the standard employed is such that it subjects all investment and other non-business income to apportionment, without distinguishing between operating and holding company activities of a multi-state corporation. Obviously all assets contribute to "a scheme of corporate functioning and potency". Thus, this rationale leads to clearly unconstitutional results such as imposing a substantial tax on a holding company domiciled elsewhere merely by virtue of that company's investment in a small parcel of Pennsylvania rental real state. *See Commonwealth* v. *Kirby Estates, Inc.*, 432 Pa. 103, 246 A.2d 120 (1968) (Roberts, J., dissenting).

If the rationale of the Pennsylvania court is allowed to stand, it will undoubtedly be adopted by other jurisdictions and will erode the distinctions between business and nonbusiness income, which heretofore have served to confine the application of apportionment formulae within constitutional bounds. Even the many states adopting the Uniform Act, loath to let a bonanza in increased tax revenues slip by, can be expected to use this rationale as a means of classifying gains similar to those taxed in *Emhart*

as "business income,"[10] thereby avoiding the allocation of such gains to the state of taxpayer's commercial domicile as provided by Section 6(c) of the Uniform Act and taxing such gains through application of the apportionment formula. See Appendix E, p. 64, *infra*. The result, of course, will be multiple taxation and tax levies disproportionate to taxpayer's activity within the taxing state, as occurred in *Embart*. The confusion, inconsistencies and inequitable burdens imposed on multi-state corporations will be further increased, with the consequence that corporations engaged in multi-state activities will be forced to resort to "unhealthy fragmentation of enterprise and an uneconomic pattern of plant location" of the sort condemned by this Court in *General Motors Corp.* v. *District of Columbia, supra*, at 560.

CONCLUSION

This appeal raises a timely question of fundamental importance concerning constitutional limitations on the state taxing power as applied to the unrelated investment income of a foreign corporation, which must be resolved clearly by this Court if state taxation of the extra-territorial income of multi-state corporations under our federal system

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[10] Mr. Justice Frankfurter noted the propensity of states "to absorb more than their share of revenue" and warned against unconstitutional abuses of such formulae dissenting from a decision upholding the application of an income apportionment formula to corporations engaged exclusively in interstate commerce. *Northwestern Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 474-475 (1959).

is to proceed on a reasonable, equitable and uniform basis.

Respectfully submitted,

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APPENDIX A

COMMONWEALTH OF PENNSYLVANIA

v.

EMHART CORPORATION, Appellant.

Supreme Court of Pennsylvania.

June 28, 1971.

278A. 2d. 916

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Before JONES, EAGEN, O'BRIEN, ROBERTS and POMEROY, J.J.

OPINION OF THE COURT

ROBERTS, *Justice.*

Two issues are presented in this appeal: (1) whether appellant Emhart Corporation, in computing its Pennsylvania Corporate New Income Tax for 1964, properly ex-

cluded its capital gain realized on the sale of Monsanto Chemical Company stock from income to be allocated to Pennsylvania on the ground that the capital gain was unrelated to appellant's Pennsylvania business and bore no relation to the exercise of the privilege of doing business in Pennsylvania; and (2) whether, in computing its Pennsylvania Corporate Net Income Tax for 1964, appellant properly deducted its subpart F income (as defined by Section 952 of the Internal Revenue Code) and the taxes deemed to have been paid thereon as dividends received from any other corporation as provided for in Section 2(1) (b) of the Corporate Net Income Tax Act, Act of May 16, 1935, P.L. 208, § 2, as amended, 72 P.S. § 3420b subd. 1(b). We agree with the Court of Common Pleas of Dauphin County (Commonwealth Docket)[1] that the exclusion of the capital gain was erroneous. However, we disagree with the view that the deduction of the dividend by appellant was improper and accordingly reverse that portion of the trial court's order.

I. *Exclusion of Capital Gain*

The pertinent facts have been stipulated by the parties. Emhart *Manufacturing* Company was originally a business corporation organized under the laws of Delaware in 1922 for the purpose of manufacturing glassmaking and packaging machinery and equipment. Its plant and principal office were located in Connecticut, and from the time of its incorporation until June 30, 1964, the date of its merger with appellant, it owned no offices or plants in Pennsyl-

[1] Now the Commonwealth Court, see Pennsylvania Constitution, Art. V, Sec. 4 as implemented by The Commonwealth Court Act, Act of January 6, 1970, P.L. (1969) 434, 17 P.S. § 211.1 et seq. (Supp. 1971); see also, Appellate Court Jurisdiction Act of 1970, Act of July 31, 1970, P.L. —, Art. IV, 17 P.S. § 211.401 et seq. (Supp. 1971).

vania.

American Hardware Corporation (appellant, under a former name) was originally in the business of manufacturing builders' hardware, with its principal plant and home office in Hartford, Connecticut. In time, American Hardware expanded its business to include the manufacture of sporting firearms and refrigeration equipment; in the process, it acquired a plant in Lancaster, Pennsylvania on March 1, 1962.

Then, on June 30, 1964, Emhart *Manufacturing* Company and American Hardware Corporation merged with American Hardware being the surviving corporation. No gain or loss was recognized for federal tax purposes. The survivor's name was changed to Emhart Corporation—appellant in the present case.

Certain corporate acquisitions prior to the merger must be set forth. In 1935, Emhart *Manufacturing* Company incorporated Plax Corporation in Delaware to develop inventions of the Fernplas Corporation, another Delaware corporation. Emhart *Manufacturing* eventually acquired Fernplas for cash and liquidated it into itself, thereby gaining title to any patents owned by Fernplas. Plax continued to develop machinery and to manufacture plastic products. Its home office and plant were located in Connecticut.

In 1953, Emhart *Manufacturing* sold one-half of the stock of Plax to Owens-Illinois Glass Company. In 1957, Owens-Illinois in turn transferred its one-half interest in Plax to Monsanto Chemical Company in exchange for Monsanto stock. In 1962, Monsanto acquired the remaining one-half of Plax stock from Emhart *Manufacturing* in exchange for

Monsanto stock. As a result of these transactions, Emhart *Manufacturing* acquired a total of 308,219 shares of Monsanto common stock.

In February, 1964, Emhart *Manufacturing* borrowed $30,000,000 from the Bankers Trust Company in New York. At the time of the loan, merger negotiations between Emhart *Manufacturing* and appellant were already underway. The bank, Emhart *Manufacturing,* and appellant had an unwritten understanding that if any of Emhart *Manufacturing's* Monsanto stock were sold, the proceeds would be used to reduce the $30,000,000 loan.

When Emhart *Manufacturing* received the $30,000,000, it immediately used the money to acquire 602,089 shares of American Hardware Corporation's stock at $50 per share, to forestall attempts by various persons to gain control of appellant. The largest block of stock, which amounted to approximately 42 percent of that outstanding on appellant's books, had been held by Glen Alden.

To capsulize, when appellant (then American Hardware Corporation) and Emhart *Manufacturing* merged on June 30, 1964, Emhart *Manufacturing* owned 602,089 shares of appellant's stock and 308,219 shares of Monsanto stock, while owing $30,000,000 to the Bankers Trust Company. Subsequent to the merger, appellant (now Emhart Corporation) retired the 602,089 shares of its own stock acquired in the merger.

On November 19, 1964, appellant sold 180,598 shares of Monsanto for $15,000,000. The proceeds and an additional $10,000,000 were used to reduce the $30,000,000 indebtedness which appellant had acquired in the Emhart *Manu-*

facturing merger.

Appellant reported a capital gain of $13,637,858 on Schedule D of its federal income tax return by reason of the sale of Monsanto stock. In computing the income to be allocated to Pennsylvania on the Pennsylvania Corporate Net Income Tax report, appellant excluded the capital gain derived from the Monsanto stock sale. Its return discloses a net income to be allocated of $5,740,012. On the other hand, the Commonwealth's original settlement of appellant's Corporate Net Income Tax for that year shows a net income to be allocated of $19,892,697. The difference of $14,152,685 consists of the $13,637,858 capital gain on the sale of Monsanto stock and the $514,827 of subpart F income and taxes discussed in a separate portion of this opinion.

Appellant filed a timely petition for resettlement, which was refused. Appellant then petitioned for review before the Board of Finance and Review, which was also refused. Emhart next appealed to the Court of Common Pleas of Dauphin County (Commonwealth Docket). After an original appeal bond was filed, the matter was tried before the court en banc upon a stipulation of facts and agreement to try without a jury. On January 2, 1970, the court denied relief in a per curiam order. Appeal was taken to our Court. Pursuant to Rule 63 of our Rules, The Dauphin County Court (Swope, P. J.) filed an opinion on May 26, 1970, indicating its reasons for the issuance of its January 2, 1970 order.

Appellant stresses with regard to the capital gain question that the Monsanto stock sale bears no relation to the value of its Pennsylvania franchise or the exercise of its privilege of doing business in Pennsylvania. We are un-

persuaded.

A corporate taxpayer can exclude income from its income tax return in this Commonwealth for two reasons: " • • • the taxpayer either (1) is engaged in a separate business outside of Pennsylvania (the so-called 'multiform' concept) or (2) owns an asset or assets unrelated to the exercise of its franchise or the conduct of its activities in Pennsylvania (the so-called 'unrelated asset' concept)." *Commonwealth* v. *ACF Industries, Inc.*, 441 Pa. 129, 135, 271 A.2d 273, 276 (1970). Appellant admits that its numerous divisions and foreign and domestic subsidiaries were treated as a unitary business enterprise for corporate net income tax purposes. Hence, the instant case is unlike *Commonwealth* v. *Columbia Gas & Electric Corporation*, 336 Pa. 209, 8 A.2d 404 (1939), where the Court concluded that the taxpayer was engaged in a multiform business, and only that portion of the business conducted in Pennsylvania could be considered for tax purposes. Since Emhart Corporation is admittedly a unitary business, if it is to prevail on the capital gain issue, it must do so on the unrelated asset theory.

Initially we note that in determining the amount of net income allocable to the state, the burden is on the taxpayer to show by clear and cogent evidence that the taxing formula resulted in extraterritorial values being taxes. *Commonwelath* v. *American Telephone and Telegraph Company*, 382 Pa. 509, 516 n. 2, 115 A.2d 373, 376 n. 2 (1955); cf. *Butler Brothers* v. *McColgan, Franvhise Tax Commissioner of California*, 315 U.S. 501, 62 S.Ct. 701, 86 L.Ed. 991 (1942). The proper standard to be utilized in evaluating whether a taxpayer has satisfied his burden as to an unrelated asset is to determine if there is clear evidence that the asset is not "a necessary part of the corporate

activity,' " *Commonwealth* v. *Mundi Corporation*, 346 Pa. 482, 484, 30 A.2d 878, 879 (1943); accord, *Commonwealth* v. *Baxter, Kelly and Faust, Inc.*, 53 Dauph. 73 (1943). This was the standard used by the trial court, and we believe its determination of this issue was correct.

An analysis of the transaction reveals that it was more than a capital restructuring designed to increase shareholder equity in Emhart by means of a purchase and cancellation of its issued and outstanding shares—a view urged by appellant. As a result of the merger, Emhart acquired, inter alia, the Monsanto stock and the $30,000,000 indebtedness. The latter became an item of general indebtedness for appellant, which was concededly a corporation engaged in a unified business enterprise in furtherance of its corporate development both within and outside of this Commonwealth.

Appellant contends that because it did not treat the Monsanto stock as a general asset, carried the stock in a separate investment account, and used the stock dividends for charitable purposes, its business activity was in no way related to this asset. We disagree.

All cash dividends produced by the Monsanto stock were retained for Emhart's general corporate purposes. Furthermore, as the trial court stressed, appellant consented to a restriction on the use of the stock sale proceeds. A relationship was thus created between the stock and the debt, and the stock was in fact used to retire a portion of Emhart's general indebtedness. We believe the capital gain proceeds from this sale contributed substantially to a scheme of corporate functioning and the business potency of appellant, and accordingly should be considered in the

determination of appellant's income allocable to Pennsylvania. See *Commonwealth* v. *United Biscuit Company,* 56 Dauph, 163, 171 (1944).

Finally on this issue, we are unmoved by appellant's argument that the Monsanto stock sale should not be taxed because had the merger been accomplished by a reorganization pursuant to Section 368(a) (1) (B) of the Internal Revenue Code, a sale of the Monsanto stock by Emhart *Manufacturing* Company would not have been imputed to appellant. Different tax consequences follow from the choice of any of the six types of reorganization set forth in Section 368(a) (1), and considerable tax planning is necessary to perceive the most desirable alternative in a given situation, for the federal statutory scheme relating to corporate reorganizations is as complex as any in the Code (or elsewhere).[2]

Appellant did not utilize a B reorganization, and the

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[2] If a business transaction qualified as a "reorganization" under Section 368(a) (1) of the Internal Revenue Code, various other operative rules of the Code provide that no gain or loss will be recognized at that time. See, e.g., sections 354, 356, 357, 358, 361, 362(b), and 381.

"Reorganization" is a term of art, and can include mergers, consolidations, recapacitations, acquisitions, and changes in form or place of organization. The statutory definition looks primarily to form, rather than substance, however, which is the weakness of appellant's argument. The form of the reorganization is often crucial. In practice, the basic patterns of the six types of reorganizations—(statutory mergers and consolidations (Type A), acquisitions by one corporation of the stock or assets of another (Types B and C), transfers to uncontrolled corporations (Type D), recapitalizations (Type E), and changes in form or place of organization (Type F)—often overlap, so that, as two of the foremost authorities in this area have observed: "* * * tax consequences may vary depending upon which statutory category of reorganization is deemed controlling. This, in turn, may depend on the form of the transaction, the amount and character of the consideration exchanged, and the change in the parties' legal and economic relationships to the properties involved and among themselves." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders 507 (2d ed. 1966).

hypothetical tax liability under that situation is not now before us. The fact remains that it was appellant who sold the Monsanto stock. We do not believe appellant has met its burden of demonstrating that the asset was clearly unrelated to its corporate enterprise.

II. *Deduction of Subpart F Income*

Section 2 of the Corporate Net Income Tax Act, supra, defines net income as " * * * taxable income for the calendar year or fiscal year as returned to and ascertained by the Federal Government * * *." Act of May 16, 1935, P.L. 208, § 2, as amended, 72 P.S. § 3420b, subd. 1(b). However, the same section contains a proviso that " * * * additional deductions shall be allowed from taxable income on account of dividends received from any other corporation but only to the extent that such dividends are included in taxable income as returned to and ascertained by the Federal Government * * *." Id.

Pursuant to this provision, appellant deducted $514,827 from its tax base in its 1964 Corporate Net Income Tax report. That sum consisted of $382,447 of "subpart F income" as defined by Section 952 of the Internal Revenue Code[3] and taxes paid on the subpart F income in the amount

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[3] The statute provides:

"(a) In general.—For purposes of this subpart, the term 'subpart F income' means, in the case of any controlled foreign corporation, the sum of—

(1) the income derived from the insurance of United States risks (as determined under section 953), and

(2) the foreign base company income (as determined under section 954).

"(b) Exclusion of United States income.—In the case of a controlled foreign corporation, subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax)

of $132,380, as required by Sections 78 and 960 of the Code.

While it concedes that the amount claimed by appellant as a deduction is a "dividend" according to the Federal Government, the Commonwealth challenges that deduction because the pertinent language in Section 2, quoted above, refers to dividends "received". Emhart did not in fact physically receive the dividends during the 1964 tax year, and the Commonwealth urges that the deduction is consequently improper. The trial court agreed.

pursuant to a treaty obligation of the United States.

"(c) Limitation.—For purposes of subsection (a), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year reduced by the amount (if any) by which—

(1) an amount equal to—

(A) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1962, plus

(B) the sum of the deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963 (reduced by the sum of the earnings and profits for such taxable years); exceeds

(2) an amount equal to the sum of the earnings and profits for prior taxable years beginning after December 31, 1962, allocated to other earnings and profits under section 959(c) (3).

"For purposes of the preceding sentence, any deficit in earnings and profits for any prior taxable year shall be taken into account under paragraph (1) for any taxable year only to the extent it has not been taken into account under such paragraph for any preceding taxable year to reduce earnings and profits of such preceding year.

"(d) Special rule in case of indirect ownership—For purposes of subsection (c), if—

(1) a United States shareholder owns (within the meaning of section 958(a)) stock of a foreign corporation, and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and

(2) any of such foreign corporations has a deficit in earnings and profits for the taxable year,

then the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, with respect to such United States shareholder, be properly reduced to take into acount any deficit described in paragraph (2) in such manner as the Secretary or his delegate shall prescribe by regulations."

The defect with the Commonwealth's position on this issue in our view is that, if nothing else, Section 2 of the Pennsylvania Corporate Net Income Tax Act evinces a clear legislative determination that a corporation at some point is entitled to a deduction for dividends received from other corporations, presumably to avoid a double tax at the corporate level. The pertinent statutory language states that the deduction is allowed if the "* * * dividends are included in taxable income as returned to and ascertained by the Federal Government * * *." Act of May 16, 1935, supra, 72 P.S. § 3420b, subd. 1(d). It is therefore apparent that unless a dividend is reported to the Federal Government, it is not entitled to be deducted on the Pennsylvania return. Hence, if a corporation fails to take the deduction in the year it included the dividend in its federal return, it is unclear whether the corporation can ever take advantage of the deduction in a later year, for while the corporation will have "received" the dividend, it will not have included that sum in its federal return—a prerequisite for the deduction.

Confronted with this dilemma, it is our view that the overriding policy concern should be the Legislature's determination that corporations have the benefit of this deduction. As we observe in *Commonwealth* v. *General Refractories Company*, 417 Pa. 153, 207 A.2d 833 (1965):

"While the precise language of the Act is not a model of clarity in regard to the question before us, we are convinced that the adjustment to taxable income for dividends received can be explained only in terms of the Federal Code. The dividends received deduction stated in the Act is primarily an extension of the already permitted 85% deduction allowed by the Code; and it would be illogical to

hold that while the latter 85% is determined by reference to the federal concept of dividends, the former 15% is computed only by reference to some differing state standard. That the state deduction also encompasses a 100% deduction when the dividends received are from certain foreign corportaions does not alter our conclusion. It is not the quantum of source of the dividend that governs; it is the nature of the receipt. Pennsylvania has chosen to treat all dividends alike, no matter what their source, as long as they are included in federal taxable income. * * *

"* * * *

"* * * If a particular receipt is includible in federal gross income as a dividend, then its characterization as such must follow through to the full state deduction for dividends received, whether this be for the remaining 15% of dividends received from United States corporations or the entire 100% received from certain foreign corporations."

Id. at 161—162, 207 A.2d at 837 (footnote omitted).

It is therefore our view that the Court of Common Pleas of Dauphin County correctly determined that appellant improperly excluded $13,657,858 of capital gain from its Corporate Net Income Tax report, but incorrectly held that a deduction of subpart F income in the amount of $514,827 was also improper.

The order of the Court of Common Pleas of Dauphin County is modified to provide that appellant's net income to be allocated to Pennsylvania in 1964 was $19,377,870. Taxes and interest should be assessed accordingly, and the

record is remanded for the entry of judgment consistent with this opinion.

BELL, C. J., did not participate in the consideration of this case.

COHEN, J., did not participate in the decision of this case.

APPENDIX B

COMMONWEALTH OF PENNSYLVANIA

v.

EMHART CORPORATION

IN THE COURT OF COMMON PLEAS OF

DAUPHIN COUNTY, PENNSYLVANIA

No. 185 COMMONWEALTH DOCKET, 1967

OPINION

BY THE COURT:

Emhart Corporation (hereinafter sometimes referred to as "Emhart") has filed its appeal from the action of this Court in its Order dated January 2, 1970, whereby Emhart's appeal from the decision of the Pennsylvania Board of Finance and Revenue refusing to resettle its corporate net income tax for the year 1964 was denied per curiam.

Upon notice of the appeal, pursuant to Rule 63 of the Pennsylvania R. C. P., we file the following statement, in the form of an Opinion, setting forth our reasons for denying the appeal.

This matter was tried initially before the Court en banc on a stipulation of facts and agreement to try without a jury, both filed of record pursuant to the provisions of the Act of April 22, 1874, P. L. 109, 12 P.S. 689. We adopt as

our Findings those facts which are contained in the aforementioned stipulation. Such of them as are deemed necessary or pertinent to our decision will be deferred to hereinafter.

This appeal concerns two questions which, except for the fact that they both arise out of the settlement of tax on Emhart's 1964 C. N. I. Report, are unrelated, have no effect one upon the other, and will, therefore, be treated separately herein.

The Corporate Net Income Tax of May 16, 1935, P.L. 208, 72 P.S. 3420 et seq., as reenacted and amended provides in paragraph 1(b) of Section 2, in part, as follows:

> "Net Income
>
> '... taxable income as returned to and ascertained by the Federal Government ...'
>
> '... and provided further, that additional deductions shall be allowed from taxable income on account of dividends received from any other corporation'."

Pursuant to this provision of the statute, Emhart claimed a deduction from the tax base in its C. N. I. report for the year in question of the amount of $514,827.00, which was comprised of "Subpart F income" as defined by Section 952 of the Internal Revenue Code of 1954, as amended, in the amount of $382,447.00 and taxes deemed to have been paid in respect thereto in the amount of $132,380.00, as required by Section 960 and 78 of the Code. In support of its claim, Emhart relies upon the holding of *Commonwealth* v. *General Refractories Co.*, 417 Pa. 153 (1965), affirming 81 Dauphin

126 wherein it was established that in their application of the dividends deduction clause of the Pennsylvania Corporate Net Income Tax Act, the taxing authorities of the Commonwealth will be bound by the Federal determination of what constitutes a "dividend" under the Code. The Commonwealth here concedes this point and agrees that the amount claimed by Emhart as a deduction, having been designated as "dividends" income by the Federal taxing authority, must also be so considered by the Pennsylvania taxing authorities.

The Commonwealth insists, however, that while the General Refractories case clearly establishes that Emhart's Subpart F income must be recognized in Pennsylvania as "dividends" income, the opinion in that case makes no determination that the designation of Subpart F income must be given impact by the Pennsylvania authorities in settling taxpayer's Corporate Net Income Tax for the very same year as that in which the Federal taxing authority thus characterized the item. Since Emhart concedes that no part of its "Subpart F" income was in fact actually received during the tax year in question, the Commonwealth contends that it may rely upon the plain wording of the Pennsylvania statute which limits the deduction for dividends to those "received" and thus refuse to give effect to any claim for deduction unless or until the actual receipt thereof is established by the taxpayer.

Emhart, as appellant herein, has the burden of proof in support of its appeal, and, as a taxpayer seeking the benefit of exemptive language in the taxing statute, it must bear the onus of strict construction of the terms thereof. In satisfaction of these burdens, it relies upon the following language which occurs in the General Refractories opinion,

supra, at page 162:

> "If a particular receipt is *includible* in federal gross income as a dividend, then its characterization as such must follow through to the full state deduction for dividends received, whether this be for the remaining 15% of dividends received from United States corporations or the entire 100% received from certain foreign corporations." (emphasis supplied)

From this language, Emhart argues that the governing factor is not physical receipt but "includibility," whether by actual or constructive receipt. We do not agree that this language requires, nor do we think it contemplates such sweeping interpretation. As we read it, this particular language relates rather to exceedingly fine points incident to the application of the principal holding of the General Refractories case which are not here in issue and which, having already been most clearly developed in that opinion, need not for our present purposes be here again pursued.

Nowhere in the opinion, nor in the Pennsylvania statutes, nor elsewhere have we found, nor have we been furnished, authority to indicate any requirement that the word "received" as it occurs in the particular provision of the C.N. I. Act pertinent to our consideration must be taken to mean anything other than "actually" received, even though this may mean that a taxpayer's right to a "dividends" income deduction may be delayed in Pennsylvania beyond the year in which it falls into "Subpart F" income for Federal purposes until such time as it has actually been received by the taxpayer. Accordingly, we are of the opinion that the Commonwealth's position on this first question is well taken and that the taxpayer has failed to substan-

tiate its position in this regard.

Emhart also seeks in its brief and argument to raise the constitutional issue of uniformity with regard to this first question. No such issue was raised in this respect at any stage of the administrative review procedures, nor in the Appeal and Specification of Objections to which we presently address ourselves. This belated attempt to raise this issue appears clearly violative of the provisions of Section 1104 of the Pennsylvania Fiscal Code, 72 P.S. 1104, the provisions of which are mandatory on this court. See *Commonwealth* v. *Second National Bank of Meyersdale,* 88 Dauphin 7 (1967); *Commonwealth* v. *Bogus,* 88 Dauphin 94 (1967); *Commonwealth* v. *Koppers Company,* 397 Pa. 523 (1959). Accordingly, the question will not be herein considered.

The second and remaining issue set forth in this appeal arises out of the refusal of the Pennsylvania taxing authorities to permit Emhart to deduct from its tax base in the year in question an amount of $13,637,858.00 as being a gain from the sale of an intangible asset which was unrelated both to Emhart's Pennsylvania franchise and to its general business operations. It is conceded that Emhart is engaged in a unitary business operation for purposes of Pennsylvania corporate net income tax and that it is a sizable business corporation engaged through numerous subsidiaries in a variety of enterprises through the United States. The cases have firmly established that the method of apportionment of the income of a corporate taxpayer doing business both within and without the Commonwealth which is prescribed by the Pennsylvania Corporate Net Income Tax Act so that only that portion of the corporation's income which is fairly allocable to this State is sub-

jected to tax is constitutional. It is possible for a corporate taxpayer to show, however, through the establishment of the multiform nature of its operation that the application of the formula against it without special recognition of that extraordinary circumstance *would work an unconstitutional result*. Likewise, as is the case at hand, a corporate taxpayer which is basically unitary in nature may nevertheless make the same claim of unconstitutional result with regard to inclusion in the tax base of a gain or gains arising out of the sale of an asset or assets claimed to be wholly unrelated to the taxpayer's Pennsylvania activities or to its business generally. To amount to a breach of the constitutional safeguards, the misapportionment must be palpable, and the burden is on the defendant to satisfy that exacting test. *Underwood Typewriter Company* v. *Chamberlain*, 254 U.S. 113 (1920).

In order to better understand Emhart's claim with regard to the "unrelated asset" question, we must look to certain facts and circumstances surrounding the corporation prior to the tax year in question.

Emhart *Manufacturing* Company (not the defendant) was originally a Delaware corporation incorporated in 1922 with its plant and principal office in Connecticut. It originally was engaged in the manufacture of glass making and packaging machinery and equipment. (S/F 7)

Emhart *Manufacturing* Company, from the time of its incorporation to June 30, 1964, had no offices or plants located in Pennsylvania. (S/F 8)

American Hardware Corporation (defendant herein; defendant's name was formerly American Hardware Corpo-

ration) was originally in the business of manufacturing builders' hardware, with its principal plant and home office in Hartford, Connecticut. Over the years, through acquisitions, American Hardware Corporation (defendant herein) expanded its business to include the manufacture of sporting fire arms (Savage Arms Co.) and refrigeration equipment (formerly C. V. Hill Co., Trenton, N. J.) and in the process, acquired additional plants in a number of states including, on March 1, 1962, a plant in Lancaster, Pennsylvania. (S/F 9)

On June 30, 1964, Emhart *Manufacturing* Company was merged into American Hardware Corporation in a tax-free merger (under Federal Law), with defendant being the surviving corporation. Defendant's name was changed from American Hardware Corporation to Emhart Corporation (the named defendant, herein). (S/F 10)

In 1935, Emhart *Manufacturing* Company (not defendant), formed Plax Corporation (hereinafter referred to as "Plax") under the laws of Delaware as a development company to develop inventions of another company called Fernplas Corporation (hereinafter referred to as "Fernplas"). Fernplas, also a Delaware corporation, was the owner of certain patents which Plax was to develop. Emhart *Manufacturing* Company subsequently acquired Fernplas for cash and liquidated it into itself, thereby acquiring clear title to all of the Fernplas patents. Plax continued to develop machinery and engaged in manufacturing plastic products with its plant and home office in Connecticut. Plax was continued for a time as a wholly owned subsidiary of Emhart *Manufacturing* Company. (S/F 11)

In 1953, Emhart *Manufacturing* Company sold one-half

of the stock of Plax to Owens-Illinois Glass Company. In 1957 Owens-Illinois Glass Company transferred its one-half interest in Plax to Monsanto Chemical Company (hereinafter referred to as "Monsanto") in exchange for stock of the latter corporation. This resulted in Monsanto owning one-half of the stock of Plax and Emhart *Manufacturing* Company continuing to own the other one-half. (S/F 12)

In 1962, Monsanto acquired the other one-half of the Plax stcok from Emhart *Manufacturing* Company in exchange for Monsanto stock, which exchange was tax-free under Federal income tax law. As a result of this transaction, Emhart Manufacturing Company acquired a total of 308,-219 shares of Monsanto common stock. (S/F 13)

In February 1964, Emhart Manufacturing Company borrowed $30,000,000 from Bankers Trust Co., New York City. At the time this loan was negotiated, merger talks between Emhart Manufacturing Company and defendant had already been underway. It was the understanding of the bank, defendant and Emhart *Manufacturing* Company that if any of Emhart *Manufacturing* Company's Monsanto stock were sold, the proceeds would be applied to reduce the $30,000,000 loan. Said understanding was not reduced to writing by the parties. (S/F 14)

Upon receipt of the $30,000,000 loan by Emhart *Manufacturing* Company, the entire $30,000,000 was immediately used in the purchase of 602,089 shares of defendant's stock at $50 per share. These shares had been owned by various persons who had been attempting to gain control of defendant. The largest block was held by Glen Alden which block represented approximately 42 percent of defendant's outstanding stock. (S/F 15)

On June 30, 1964, the date of the merger of Emhart *Manufacturing* Company into defendant, there was a loan outstanding on the books of Emhart *Manufacturing* Company of $30,000,000 and Emhart *Manufacturing* Company owned 602,089 shares of defendant's stock and 308,219 shares of Monsanto stock. (S/F 16)

In 1964, defendant retired the 602,089 shares of its stock acquired in the merger with Emhart *Manufacturing* Company. (S/F 17)

On November 19, 1964, defendant sold 180,598 shares of Monsanto stock to a syndicate headed by Harriman Ripley and Company, Inc., 60 Broad Street, New York City, for $15,000,000. The entire proceeds of such sale for $15,000,000 together with $10,000,000 of other cash, were used to pay off $25,000,000 of the aforesaid $30,000,000 loan payable which defendant acquired in the Emhart *Manufacturing* Company merger. (S/F 18)

Defendant reported a capital gain of $13,637,858 on Schedule D of its Federal income tax return by reason of the sale of Monsanto stock. (S/F 19)

In computing the income to be allocated to Pennsylvania on the Pennsylvania Corporate Net Income Tax Report, defendant deducted the capital gain of $13,637,858 realized from the sale of the Monsanto stock. (S/F 20)

Defendant, after the tax year in question, and up until the time of this appeal, continued to hold 100,000 shares of Monsanto stock in an account entitled "Monsanto Company Common Stock".

During the period 1964-1967, the Monsanto Company paid a two percent stock dividend. Defendnat has contributed each stock dividend it has received to a charitable foundation. All cash dividends paid on the Monsanto stock have been retained by defendant for general corporate purposes. (S/F 22)

Defendant, in its 1964 Corporate Net Income Tax Return, listed the ownership of securities, the book value of which approximated $21,000,000 and the actual value approximated $34,000,000. This list of securities included that portion of the Monsanto stock remaining in defendant's ownership after the sale of the shares in question. (S/F 23)

For the fiscal year 1964, the defendant operated the following divisions:

Hartford Division, Hartford, Connecticut — Manufactures glass producing equipment and supplies engineering services to the glass industry.

Standard-Knapp Division, Portland, Connecticut — Manufactures packaging equipment.

Hill Refrigeration Division, Trenton, New Jersey—Designs and manufactures refrigerated display cases and walk-in refrigerators.

P. & F. Corbin Division, New Britain, Connecticut — Markets locks and architectural hardware.

Russwin Division, New Britain, Connecticut — Manufactures builders hardware.

Kwikset Division, Anaheim, California — Manufacturers residential locksets.

Corbin Wood Products Division, Hornell, New York — Manufacturers and designs key and dial operated letter boxes.

Corbin Cabinet Lock Division, New Britain, Connecticut — Sells specialized locking devices.

Savage Arms Division, Westfield, Massachusetts — Manufactures a broad line of firearms.

Corbin Hose Clamp Division, New Britain, Connecticut— Manufactures and sells hose clamps.

All of the above divisions and foreign and domestic subsidiaries were treated by defendant as a unitary business enterprise for Pennsylvania Corporate Net Income Tax purposes. (S/F 24)

All of the Monsanto stock acquired by Emhart *Manufacturing Company* was reflected in an investment account entitled "Monsanto Company Common Stock".

The Monsanto stock at all times remained in the possession of Emhart *Manufacturing* Company. At no time did it physically pledge, hypothecate or collateralize such stock to secure loans or other indebtedness. Such stock constituted an asset of the corporation which general creditors would look to in appraising the financial condition of the company.

All of the Monsanto stock acquired by defendant has remained in its possession. At no time did it physically pledge, hypothecate or collateralize such stock to secure loans or other indebtedness. Such stock constituted an asset of the corporation which general creditors would look to in appraising the financial condition of the company. (S/F 25)

In determining the constitutional issues which have been raised relative to allocation, the same principles are applicable to both the franchise and corporate net income tax. See *Commonwealth* v. *Baker-Whitely Coal Co.*, 74 D. & C. 13 (1950), where this court, after citing the leading franchise tax case of *Commonwealth* v. *Columbia Gas and Electric Corporation*, 336 Pa. 209 (1939), stated at pp. 17-18 as follows:

> "The same principles should apply to the corporate net income tax. It, too, is a privilege tax. The measure thereof is the income derived from the exercise of the privilege. In determining the validity of the tax, we must separate from the income that portion thereof which has no relation to the privilege."

Even so, upon examining the cases principally relied upon by Emhart, we feel that each of them may be distinguished on its facts from the case at hand.

Commonwealth v. *Kirby Estates, Inc.*, 432 Pa. 103 (1968) may be distinguished here on the same basis upon which it was differentiated in the case of *Commonwealth* v. *ACF Industries, Incorporated*, 91 Dauphin 239 at p. 247:

> ". . . But on close analysis, the very nature of the ap-

pellant's corporate activities are patently different from Kirby. It is a general business enterprise and is engaged in many activities within and without the Commonwealth. Kirby's two operations were readily delineated and the tax encompassed only the operations within this State."

Commonwealth v. *The Mundy Corporation*, 346 Pa. 482 (1943) and *Commonwealth* v. *Baxter, Kelly and Faust, Inc.*, 53 Dauphin 73 (1943), involved investment in securities of capital contributions of share holders or of accumulations from income respectively. In each instance the court found that the securities purchased did not form a part of the working capital of the corporation, did not form a part of its reserves, and did not constitute "a necessary part of the corporate activity". In Mundy, the securities had been held in the main from the date of taxpayer's incorporation and in Baxter, Kelly and Faust the securities had similarly been held undisturbed by the corporation for significant periods of as much as two years.

In the instant case, the Monsanto stock in question, having been acquired by Emhart in the merger of June 30, 1964, was held by the corporation for a relatively short period (approximately four and one-half months) and was then sold and the proceeds, including the gain here involved, utilized to satisfy a portion of the general indebtedness which Emhart had also acquired as a result of the merger. We are unwilling, as suggested by Emhart, to consider either the Monsanto stock or the obligation to repay the debt of $30,000,000 as being continuingly ascribable to Emhart *Manufacturing* Company beyond June 30, 1964, the effective date of the merger, upon which date Emhart *Manufacturing* went out of existence. From that date for-

ward, Emhart, as survivor in the merger, is the only shareholder or debtor whose existence may be said to have continued for purposes of our present consideration.

We do not feel that the disposition to charity of stock dividends on the Monsanto shares held is entitled to any great weight in determining the basic issue of unrelated assets nor is the fact that the cash dividends went for Emhart's general corporate purposes. We do feel it to be most important in this regard, however, that when Emhart sold Monsanto stock, the proceeds of the sale, including the gain thereon, were utilized to retire a portion of the general indebtedness of Emhart. It would seem that when Emhart, which is conceded to be a large and complex business corporation, engaged in numerous and varied activities both in Pennsylvania and throughout the United States and which is considered for purposes of the tax in question to be unitary in nature, determined to enter into negotiations which resulted in the merger of June 30, 1964, it did so in furtherance of its overall corporate development, which is in turn supportive of and most essential to its continued business activities both in Pennsylvania and elsewhere. Emhart, as a result of the merger, continued its corporate development both in and out of Pennsylvania. As a result of the merger Emhart acquired, inter alia, shares of stock of Monsanto and a $30,000,000 item of indebtdeness. During the negotiations leading to the merger, Emhart had agreed that the proceeds of sale of the Monsanto stock, if and when it should be sold would be applied to the debt. Even though Emhart, following the merger, did not treat the Monsanto stock as a general asset, did not employ it in its general corporate activity, carried the stock in a separate investment account, did not carry the stock as a reserve and did not physicaly pledge, hypothecate or col-

lateralize the stock to secure loans or other indebtedness, we are satisfied that in consenting to a restriction on the use of the proceeds of any sale thereof Emhart directly, effectively and undeniable created a relationship between the stock and the debt. This debt was an item of general indebtedness for Emhart. It was assumed by Emhart in the merger. The merger was in furtherance of Emhart's corporate development and activity both within and without Pennsylvnaia. A consideration of all of the above factors taken together is sufficient to completely negate any claim of "unrelated assets" as regards the Monsanto stock or the proceeds of any sale thereof, including gains realized. It is this factor of previously negotiated restriction on the proceeds of any sale of the Monsanto stock which differentiates this case from the ACF case, upon which both the Commonwealth and Emhart seek to rely as strongly supportive of their respective positions. In that case, wherein the factual situation was in part similar to the case at hand, we held that the gain from the sale of certain shares previously acquired by ACF with a view to a merger were properly included in the tax base. While there are sufficient differencies in the ACF case and our own to permit Emhart to distinguish the two, we fail to see any advantage to it in the ACF case thereafter. For the Commonwealth, while ACF is generally supportive of its position, it is not at all pertinent to the point here raised and which, in the instant case, we feel is the determinative factor on this issue since the point did not even exist in ACF, wherein the shares there in question were held and disposed of without restriction as to the application of the proceeds of their sale.

We conclude, therefore, that Emhart's gain from the sale of its Monsanto stock falls clearly within the scope

of the test prescribed in *Commonwealth* v. *United Biscuit Company*, 56 Dauphin 163 (1944) as stated at p. 171:

> "The test is that whatever contributes to a scheme of corporate functioning or the business potency of the corporation within the Commonwealth may be taken into consideration in ascertaining the value of the franchise in the State."

With regard to this issue of "unrelated assets" Emhart once again has the burden of proof as appellant and also must again bear the onus of strict construction since it claims the benefit of an exemptive provision of the statute, and, in addition, it must also overcome the presumption of constitutionality which is inherent both in the statute and in the application thereof. See *Commonwealth* v. *American Telephone and Telegraph Company*, 382 Pa. 509 (1955), p. 516 footnote 2:

> "... In determining the amount of property or net income allocable to the state the burden is on the taxpayer to show by clear and cogent evidence that the taxing formula resulted in extra-territorial values being taxed: *Butler Brothers* v. *McColgan*, Franchise Tax Commissioner of California, 315 U.S. 501."

We are satisfied that Emhart, with regard to this second issue, has again failed to meet its burden.

We note finally that the allocating percentage resulting from the construction of the apportionment fractions is not in dispute. Applying this percentage to the gain from the sale of the Monsanto stock in question which gain is in excess of $13,000,000, results in an increase in Emhart's liability for tax of approximately $21,000.00. We do not

conceive of this result as so unreasonable or excessive as to suggest thta the impact of the tax bears no reasonable relationship to the value of Emhart's overall activities which are properly allocable to Pennsylvania.

Conclusions of Law

1. This Court has jurisdiction in the within appeal.

2. The Commonwealth taxing authorities properly refused to allow Emhart to deduct from its income to be allocated to Pennsylvania for purposes of settlement of its 1964 corporate net income tax an amount of $514,827.00 claimed by Emhart as a "dividends received" deduction as provided for in Section 2 (1)(b) of the Pennsylvania Corporate Net Income Tax Act, as amended.

3. The Commonwealth taxing authorities properly refused to allow Emhart to deduct from its income to be allocated to Pennsylvania for purposes of settlement of its 1964 corporate net income tax an amount of $13,637,858 realized on the sale of the Monsanto stock.

4. Emhart has failed to meet its burden of proof so as to show that the Commonwealth's inclusion in the tax base of the amounts delineated in No. 2 and No. 3, above, was improper, contrary to law, or unconstitutional.

5. Emhart's appeal in the within matter must be denied.

All of the foregoing of which is respectfully submitted this 26th day of May, 1970, pursuant to Rule 63, as the reasons whereby we heretofore made our Order, dated January 2, 1970, in which the within appeal was denied

and judgment directed to be entered in favor of the Commonwealth and against Emhart Corporation.

P.J. - Orphans Court Division, Dauphin County Court of Common Pleas - Sitting in Commonwealth Court

Judge Caldwell did not participate in the consideration or determination of this case.

IN THE COURT OF COMMON PLEAS OF
DAUPHIN COUNTY, PENNSYLVANIA

No. 185 COMMONWEALTH DOCKET 1967

COMMONWEALTH OF PENNSYLVANIA

v.

EMHART CORPORATION

ORDER

NOW, this 2nd day of January, 1970, this case having been heard upon stipulation of facts and agreement to try without jury filed pursuant to the provisions of the Act of April 22, 1874, P.L. 109, and upon consideration of the record so comprised, and upon further consideration of the arguments of the parties heard by the Court, it is hereby ordered that the appeal of Emhart Corporation from the decision of the Board of Finance and Revenue wherein said Board refused the Petition for Review of the initial settlement and refusal by the taxing departments of the Petition for Resettlement of the corporate net income tax of Emhart Corporation for the year 1964 is denied and the original settlement of tax by the taxing authorities in which it was determined that for the year in question the net income of Emhart Corporation to be allocated was $19,892,697.00 from which this appeal was taken is confirmed. Judgment is directed to be entered in favor of the Commonwealth of Pennsylvania and against Emhart Corporation in the amount of $32,793.11 of which $12,909.59 having been paid interest shall be computed as provided by law upon the unpaid balance of $19,883.52 to be added thereto.

The Prothonotary is directed to give notice to the parties or their counsel of this Order forthwith.

By the Court:
Per Curiam

DEFENDANT'S EXCEPTIONS TO ORDER

COMMONWEALTH OF PENNSYLVANIA,
PLAINTIFF

v.

EMHART CORPORATION

IN THE COURT OF COMMON PLEAS
OF DAUPHIN COUNTY, PENNSYLVANIA

No. 185 COMMONWEALTH DOCKET 1967

EXCEPTIONS OF THE DEFENDANT TO PER CURIAM ORDER OF THE COURT

AND NOW, January 27, 1970, Defendant excepts to the Order of the Court, per curiam, as follows:

1. The Honorable Court erred in affirming that, for the year in question, calendar 1964, the net income of Defendant to be allocated was $19, 892,697.00, as set forth in its order:

> ". . . it is hereby ordered that the appeal of Emhart Corporation from the decision of the Board of Finance and Revenue wherein said Board refused the Petition for Review of the initial settlement and refusal by the taxing departments of the Petition for Resettlement of the corporate net income tax of Emhart Corporation for the year 1964 is denied and the original settlement of tax by the taxing authorities in which it was determined that for the year in question the net income of Emhart Corporation to

be allocated was 19,892,697.00 from which this appeal was taken is confirmed."

2. The Honorable Court erred in directing the following judgment:

"Judgment is directed to be entered in favor of the Commonwealth of Pennsylvania and against Emhart Corporation in the amount of $32,793.11 of which $12,-909.59 having been paid interest shall be computed as provided by law upon the unpaid balance of $19,883.52 to be added thereto."

3. The Honorable Court erred in refusing to make the following conclusion of law, as set forth in Defendant's Brief at pages 16 and 39:

"In computing its Pennsylvania Corporate Net Income Tax for 1964, Defendant properly deducted its subpart F income of $382,447 and the taxes deemed to have been paid thereon of $132,380 as dividends received from any other corporation as provided for in Section 2(1)(b) of the Corporation Net Income Tax Act, 72 P.S. §3420 n-2 (1)(b)."

4. The Honorable Court erred in refusing to make the following conclusion of law, as set forth in Defendant's Brief at pages 26 and 39:

"In computing its Pennsylvania Corporate Net Income Tax for 1964 Defendant properly excluded from income to be allocated to Pennsylvania, its capital gain of $13,-637,858 realized on the sale of the Monsanto stock."

5. The Honorable Court erred in refusing to make findings of fact or to adopt as its findings of fact those fasts which have been stipulated by the parties. The Honorable Court may not omit such a reference completely even though all of the facts are stipulated.

6. The Honorable Court erred in refusing to make any conclusions of law relevant to the Stipulation of Facts, and to discuss the merits of the case upon which its decision was based.

Respectfully submitted,

SHELDON M. BONOVITZ
of Duane, Morris & Heckscher
Counsel for Defendant

APPENDIX C

PENNSYLVANIA CORPORATE NET INCOME TAX ACT OF MAY 16, 1935, P.L. 208, *AS REENACTED AND AMENDED*, PA. STAT. tit 72 § 3420 (1964)

§ 3420b. Definitions

The following words, terms and phrases, when used in this act, shall have the meaning ascribed to them in this section, except where the context clearly indicates a different meaning.

"Corporation." A corporation having capital stock, joint-stock association, or limited partnership either organized under the laws of this Commonwealth, the United Sttaes, or any other state, territory, or foreign country, or dependency, and doing business in this Commonwealth, or having capital or property employed or used in this Commonwealth by or in the name of itself, or any person, partnership association, limited partnership, joint-stock association or corporation. The word "corporation" shall not include building and loan associations, banks, bank and trust cmpanies, national banks, savings institutions, trust companies, title insurance companies, beneficial life and limited life insurance companies, mutual fire, mutual casualty and mutual life insurance companies, and foreign stock companies registered in this Commonwealth and therein engaged in doing business as life, fire and casualty insurance companies, and surety companies.

"Department". The Department of Revenue of this

Commonwealth.

"Net Income." 1. In case the entire business of the corporation is transacted within this Commonwealth,

* * *

(b) For any taxable year beginning after the thirty-first day of December, one thousand nine hundred fifty-three, and ending after the fifteenth day of August, one thousand nine hundred fifty-four, except as hereinafter provided in the case of stock life insurance companies, taxable income for the calendar year or fiscal year as returned to and ascertained by the Federal Government, or in the case of a corporation participating or which has participated in prior taxable years in the filing of consolidated returns to the Federal Government the taxable income which would have been returned to and ascertained by the Federal Government if separate tax returns had been made to the Federal Government for all years affected by the filing of consolidated returns to the Federal Government, subject, however, to any corrections thereof for fraud, evasion or error as finally ascertained by the Federal Government: Provided, That in the case of corporations eligible for a manufacturing, processing or research and development exemption under the act of June 1, 1889 (P.L. 420), entitled "A further supplement to an act entitled 'An act to provide revenue by taxation' approved the seventh day of June, Anno Domini one thousand eight hundred and seventy nine," an additional deduction shall be allowed from taxable income equal to one-half the amount allowed by the Federal Government for the depreciation of buildings or structures situated in this Commonwealth or improvements thereon or improvements made thereto if such buildings, structures or improvements thereon or improvements made thereto are actually

used in manufacturing, processing or research and development conducted within this Commonwealth and they consist of those for which the actual construction or improvement project commences after August 14, 1963. Buildings, structures or improvements thereon or improvements made thereto for which an additional deduction is allowed by this section shall not include equipment, fixtures, machinery or other similar tangible property. The additional deductions from income allocated to Pennsylvania for depreciation allowed hereunder shall cease when the said additional deductions, together with the depreciation allowed by the Federal Government, equal the cost of the said buildings, structures or improvements: And provided further, That additional deductions shall be allowed from taxable income on account of [(i)] dividends received from any other corporation but only to the extent that such dividends are included in taxable income as returned to and ascertained by the Federal Government: And provided further, That no deduction shall be allowed for net operating losses sustained by the corporation during any other fiscal or calendar year: And provided further, That in the case of stock life insurance companies, "net income" for taxable years beginning in one thousand nine hundred fifty-four shall be one thousand nine hundred fifty-four life insurance company taxable income as returned to and ascertained by the Federal Government and for taxable years beginning in one thousand nine hundred fifty-five and thereafter shall be life insurance company taxable income as returned to and ascertained by the Federal Government: And provided further, That in the case of stock life, fire, casualty and indemnity insurance companies, doing business on the mutual or participating plan, the term "net income" shall not include the dividends paid to policy holders out of net income: And provided further,

That in the case of regulated investment companies as defined by the Internal Revenue Code of 1954, as amended, "net income" shall be investment company taxable income as defined in the aforesaid Internal Revenue Code of 1954, as amended.

2. In case the entire business of any corporation, other than a corporation engaged in doing business as an insurance or surety company or as a regulated investment company as defined in the Internal Revenue Code of 1954, as amended, is not transacted within this Commonwealth, the tax imposed by this act shall be based upon such portion o the net income of such corporation for the fiscal or calendar year, as defined in clause one hereof, as may be determined by allocation and apportionments made as follows:

(a) Gains realized and losses sustained from the sale or exchange of capital assets, if such assets consist of real estate or tangible personal property situated in the Commonwealth, shall be allocated to this Commonwealth.

(b) Gains realized and losses sustained from the sale or exchange of capital assets consist of real or tangible personal property situated outside of the Commonwealth, shall not be allocated in any part to this Commonwealth.

(c) The remainder of such net income shall be divided into three equal parts.

(1) Of one-third, such portion shall be attributed to business carried on within this Commonwealth, as shall be found by multiplying said one-third by a fraction, whose numerator is the value of the corporation's tangible prop-

erty situated within this Commonwealth, and whose denominator is the value of all the corporation's tangible property wherever situated. In computing the value of the corporation's tangible property situated within this Commonwealth, additional depreciation shall be allowed for buildings, structures and improvements thereon or improvements made thereto as provided in subclause (b) of clause 1 and the next to last paragraph of this subclause (c) of clause 2. The term "tangible property," as used in this subsection, shall not include the security interest of any corporation as seller or lessor in personal property sold or leased under a conditional sale, bailment lease, chattel mortgage or other contract providing for the retention of a lien or title as security for the sales price of the property.

(2) Of one-third, such portion shall be attributed to business carried or within the Commonwealth, as shall be found by multiplying said one-third by a fraction, whose numerator is the expenditures of the corporation for wages, salaries, commissions and other compensation to its employes, and assignable to this Commonwealth as hereinafter provided, and whose denominator is the total expenditures of the corporation for wages, salaries, commissions, and other compensation to all its employes.

(3) Of the remaining third, such portion shall be attributed to business carried on within the Commonwealth, as shall be found by multiplying said third by a fraction, whose numerator is the amount of the taxpayer's gross receipts from business assignable to this Commonwealth as herienafter provided, and whose denominator is the amount of the taxpayer's gross receipts from all its business. For the purpose of this section, gross receipts shall not include

receipts heretofore or hereafter received from the sale, redemption, maturity or exchange of securities, except those held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

In cases where only two of the foregoing three rules are applicable, the remainder of the net income of the corporation shall be divided into two equal parts only, each of which shall be apportioned in accordance with one of the remaining two rules. If only one of the three rules is applicable, the part of the net income recieved from business carried on within the Commonwealth shall be determined solely by that rule.

The amount assignable to this Commonwealth of expenditures of the corporation for wages, salaries, commissions, or other compensation to its employes, shall be such expenditures for the taxable year as represent the wages, salaries, commissions, or other compensation of employes, not chiefly situated at, connected with, or sent out from, premises for the transaction of business maintained by the corporation outside the Commonwealth.

The amount of the corporation's gross receipts from business assignable to this Commonwealth shall be, (1) the amount of its gross receipts for the taxable year except those negotiated or effected in behalf of the corporation by agents or agencies chiefly situated at, connected with, or sent out from, premises for the transaction of business maintained by the taxpayer outside of the Commonwealth, and except rentals and royalties, and interest and dividends, (2) rentals or royalties from property situated, or from the use of patents, within this Commonwealth, and (3) dividends and interest, except such dividends and interest attribut-

able to the business conducted on premises maintained by the taxpayer outside the Commonwealth. If a corporation maintains an office, warehouse, or other place of business in a state other than this Commonwealth for the purpose of reducing its tax under this subsection, the department shall, in determining the amount of its gross receipts from business assignable to this Commonwealth, include therein the gross receipts attributed by the corporation to the business conducted at such place of business in another state. In the case of construction contracts, negotiated or effected, at an office in the state of Pennsylvania, but performed outside the state, the gross receipts under such contracts shall be assignable outside the state, except that if the activities under any such contract to which the gross receipts are attributable shall ocur partly within the state and partly outside the state, such proportion of the gross receipts under said contract shall be assignable to Pennsylvania as the direct and indirect costs, incurred in Pennsylvania under the contract for the taxable year, bear to the total cost incurred thereunder for the taxable year. In the case of construction contracts, negotiated or effected, at an office outside the state, but performed in the state, the gross receipts under such contracts shall be assignable to the state, except that if the activities under any such contract to which the gross receipts are attributable shall occur partly within the state, and partly outside the state, such proportion of the gross receipts under said contract shall be assignable to Pennsylvania as the direct and indirect costs, incurred in the state under the contract for the taxable year, bear to the total costs incurred thereunder for the taxable year.

A rule shall not be deemed to be inapplicable merely because all the tangible property or the expenditures of a

corporation for wages, salaries, commissions, or other compensation, or the gross receipts of the corporation are found to be situated, incurred or received without the Commonwealth.

The additional deduction allowed in subclause (b) of clause 1 for depreciation on certain buildings, structures or improvements thereon or improvements made thereto situated in this Commonwealth and actually used in manufacturing, processing or research and development conducted within this Commonwealth shall be allowed to corporations whose entire business is not transacted within this Commonwealth and shall be deducted from net income as determined by allocations and apportionments as hereinabove provided.

Where a corporation in any tax year beginning on or after the first day of January, one thousand nine hundred fifty-six, engages in a separate business outside of Pennsylvania ,or owns property having a situs outside of Pennsylvania, which business or property bears no relation to the exercise of the Pennsylvania franchise, the department, with the approval of the Auditor General, may determine the base for the tax imposed by this act for the tax year by excluding from the net income of such corporation as returned to and ascertained by the Federal Government, the net income from the business or property which bears no relation to the exercise of the Pennsylvania franchise. The deduction allowed by this section for dividends received from any other corporation shall be limited to those dividends which remain in the net income after the exclusion hereinbefore authorized in this paragraph. The net income which remains, after the exclusion and deductions authorized in this paragraph, shall be subject to

allocations and apportionments as provided in this section using only those factors which pertain to that portion of the net income being allocated and apportioned.

APPENDIX D

IN THE SUPREME COURT OF PENNSYLVANIA

Middle District

No. 42, May Term 1970

COMMONWEALTH OF PENNSYLVANIA

v.

EMHART CORPORATION,
Appellant

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that Emhart Corporation, the appellant above, hereby appeals to the Supreme Court of the United States from the opinion and final judgment of the Supreme Court of Pennsylvania affirming in part the decision of the Court of Common Pleas of Dauphin County entered in this action on June 28, 1971.

This appeal is taken pursuant to 28 U.S.C. § 1257 (2).

Signed

Attorney for Emhart Corporation
Appellant

APPENDIX E

UNIFORM DIVISION OF INCOME TAX FOR TAX PURPOSES ACT

Section 1. As used in this Act, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

Section 2. Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act.

Section 3. For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net in-

come tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Section 4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in sections 5 through 8 of this Act.

Section 5. (a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in the state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty

period is unknown or unascertainable by the taxpayer tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

Section 6. (a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale, or

(2) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

Section 7. Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

Section 8. (a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state, or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commer-

cial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

Section 9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Section 10. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

Section 11. Property owned by the taxpayer is valued

at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

Section 12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

Section 13. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

Section 14. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state, or

(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state, or

(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the

service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Section 15. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

Section 16. Sales of tangible property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f. o. b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Section 17. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or

(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Section 18. If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Section 19. This Act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.

Section 20. This Act may be cited as the Uniform Division of Income for Tax Purposes Act.

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In the Supreme Court of the United States

No. 436 October Term, 1971

COMMONWEALTH OF PENNSYLVANIA,
Appellee

v.

EMHART CORPORATION,
Appellant

MOTION TO DISMISS OR AFFIRM

EDWARD T. BAKER
Deputy Attorney General
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Harrisburg, Pa.

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IN THE SUPREME COURT OF THE UNITED STATES

No. 436 October Term, 1971

COMMONWEALTH OF PENNSYLVANIA,
Appellee

v.

EMHART CORPORATION,
Appellant

MOTION TO DISMISS OR AFFIRM

Appellee moves that the present appeal be dismissed or that the final judgment of the Supreme Court of Pennsylvania be affirmed on the ground that the appeal does not present substantial federal questions.

I. STATEMENT

The Commonwealth accepts the statement of the facts of the case to the extent as stated in Appellant's Jurisdictional Statement. The Commonwealth, in addition, submits that the record in the case states that Appellant was a large industrial corporation with several divisions and producing a variety of products ranging from firearms to architectural hardware. For the purpose of the Pennsylvania Corporate Net Income Tax, Appellant has conceded that all divisions and foreign and domestic subsidiaries constitute a unitary business enterprise (R. 13a).

Appellant has never questioned the allocating percentage computed from the apportionment fractions and is attempting solely to eliminate capital gains in excess of $13,500,000 from the statutory tax base. By applying the admitted allocating percentage to this portion of the tax base, an additional tax of only $21,000 is obtained. Appellant does not question the large block of Monsanto stock which remains in its possession until the present date and other securities owned by it. Further the cash dividends received by Appellant from the Monsanto stock were retained and utilized by Appellant for general corporate purposes (R. 12a).

The opinions of the Common Pleas Court of Dauphin County and the Supreme Court of Pennsylvania sustaining the Commonwealth's tax were made by a unanimous court with two justices not partici-

pating in the Supreme Court of Pennsylvania and one judge not participating in the Common Pleas Court opinion. Appellant never petitioned the Supreme Court of Pennsylvania for a rehearing although such proceeding is specifically provided for in the Rules of the Pennsylvania Supreme Court (Rule 71, Pennsylvania Supreme Court Rules).

II. QUESTION PRESENTED

Can a corporate taxpayer eliminate from a statutory tax base the capital gain proceeds from the sale of intangible assets where the assets and proceeds contributed substantially to a scheme of corporate functioning and the business potency of the corporation within the taxing jurisdiction and the additional tax constituted less than one-fifth of one percent of the gain realized?

III. THE FEDERAL QUESTION PRESENTED IS NOT SUBSTANTIAL

1. The decision below is based substantially on the facts as stipulated by the parties, the legal precepts being clear and not in dispute.

It is conceded that where a state taxing statute utilizes as a tax base income returned to and ascertained by the Federal Government that income which bears no relationship to the franchises or privileges granted by the state must be excluded from this tax base. Upon the facts as presented to the lower courts, the opinions were unanimous that the gain from the sale of the intangible assets in question could not be so excluded by the Appellant. Each case raising similar issues will be decided primarily upon the facts as presented by the parties. Therefore, a further determination in the instant case would not act as binding precedent for any case either from the Commonwealth of Pennsylvania or any other state taxing jurisdiction.

The Pennsylvania taxing statute does provide for an apportionment fraction and in the instant matter such fraction was computed at .027475 percent, an amount not disputed by Appellant. Applying this fraction to the gain in question and thereafter applying the Pennsylvania tax rate produced additional Pennsylvania tax in the approximate amount of $21,000. This is to be compared against the capital gain

in question, in excess of $13,500,000. Since the Pennsylvania Supreme Court found as a fact that the proceeds from the sale of the asset contributed substantially to a scheme of corporate functioning or the business potency of Appellant, the application of the Pennsylvania apportionment fraction was proper and entirely constitutional.

This Court has held that in order to breach alleged constitutional safeguards the misapportionment of tax must be palpable, and the burden is on the corporate taxpayer to satisfy that exacting test. *Underwood Typewriter v. Chamberland,* 254 U.S. 113 (1920). The Pennsylvania courts, without dissent, found that there was no palpable misapportionment and that Appellant had clearly failed to meet its burden of proof. Although the record does state that the gain was taxed in the state of incorporation, and most probably in many other states, there is no claim, nor basis for a claim, that Pennsylvania's tax is confiscatory or that the total taxes imposed exceed the gain itself. Obviously such is not the case.

Appellant avers that the Uniform Division of Income for Tax Purposes Act would cure the alleged inequity in the instant case. Pennsylvania has most recently, March 1971, enacted a Corporation Income Tax incorporating many of the features of this act including distinguishing between business and non business income.[1] The act in question in the instant case will no longer be a part of the Pennsylvania tax scheme beginning with the year 1971. Thus, the

[1] Act of March 3, 1971, P. L. 5, 72 Purdon Statutes 7101 to 8203, Article IV.

opinion in the instant case would no longer be precedent in Pennsylvania since the tax act in question has been eliminated.

Contrary to Appellant's assertions before this court, the Pennsylvania courts found as facts that the gain in question was business income, was related to the Pennsylvania activities and therefore properly in the statutory tax base. By applying the unquestioned apportionment fractions to this gain, the proper tax for Pennsylvania purposes is computed.

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2. The decision below was proper on the facts submitted. It was in conformity with the tax act and consistent to other decisions of this Court and the Pennsylvania Supreme Court.

Since the Pennsylvania Supreme Court concluded on the facts as submitted that the income in question was business income and substantially related to the Pennsylvania franchises and privileges granted Appellant, Appellant's present argument based on facts not found or concluded by the lower court is inappropriate.

The Pennsylvania Supreme Court in a most recent decision has come to an opposite conclusion in a case raising identical issues because of the facts and conclusions drawn therefrom. In *Commonwealth v. ACF Industries, Inc.*, 441 Pa. 129 (1970), the corporate taxpayer argued that gain from the sale of intangible assets should be excluded from the Pennsylvania income tax base. The Pennsylvania Supreme

Court reversed the Commonwealth Court of Dauphin County and held that upon the facts as presented in that case, the corporate taxpayer had met its burden of proof by establishing the lack of connection between the income generated and the Pennsylvania activities.

The Pennsylvania Supreme Court has come to different conclusions based on facts in earlier cases raising similar issues. For example in *Commonwealth v. Minnesota Mining and Manufacturing Co.*, 402 Pa. 612 (1961), the court refused to eliminate from the tax base income generated from foreign patents, royalties and management fees.

It has been held that where intangibles enter into the exercise of a franchise conferred by the state or privileges actually exercised within the state, the value of such intangibles may properly be included in the tax base. *Newark Fire Insurance Company v. Board of Tax Appeals*, 307 U.S. 313, 319, 321 (1938). Further the burden is on the taxpayer to show by clear and cogent evidence that the taxing formula results in extra territorial values being taxed. *Butler Brothers v. McColgan, Franchise Tax Commissioner of California*, 315 U.S. 501 (1941). In *Stone v. Stapling Machines Co.*, 71 S. 2d 205 (1954), appeal dismissed 348 U.S. 802 (1954), it was stated:

> "Where the situs of the intangibles is confined to the domicile of the owner, they are of course taxed at his domicile. 'But when the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state,

> in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax'. Curry v. McCandless, 307 U.S. 357, 59 S. Ct. 900, 906, 83 L. Ed. 1339."

The additional tax imposed by the Commonwealth of Pennsylvania is less than one-fifth of one percent of the gain realized by Appellant on the sale of stock in question. This by itself negates any claim by Appellant that the tax was fundamentally improper.

IV. CONCLUSION

The appeal in question raises issues which are predominately determined by the facts of each case. The legal precepts are not in dispute. The amount of tax being contested is nominal compared to the gain realized by Appellant and there is no question as to the proper apportionment of this gain to the Pennsylvania activities of Appellant.

The Commonwealth respectfully submits that the appeal of Appellant should be dismissed and the judgment of the Supreme Court of Pennsylvania be affirmed.

Respectfully submitted,
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